In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 541

BROCKMAN BUILDING CORPORATION, INC.,
A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 126–158) are reported at 21 T. C. 175. The opinion of the Court of Appeals (R. 643–650; Pet. App. 1–9) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on September 27, 1955. (R. 651.) An order denying a petition for rehearing was entered on October 25, 1955. (R. 652.) The petition for a writ of certiorari was filed on Novem-

ber 25, 1955. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the taxpayer corporation, a lessee retaining its leasehold interest during the entire taxable period, earned taxable income when contingent rental payments, representing the taxpayer's compensation for managing the leased premises, were made by its sublessee, through the medium of a trust, directly to its stockholders and bondholders.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> (26 U. S. C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22 (a)–19. *Income to Lessor Corporation from Leased Property.*—If a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the shareholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or shareholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the shareholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns.

STATEMENT

The facts, as found by the Tax Court (R. 127–141) and summarized by the Court of Appeals (R. 643–646), are as follows:

The Security-First National Bank of Los Angeles (hereinafter referred to as the bank) owned the Brockman Building in Los Angeles as trustee under a trust established in 1922. Before 1933, the bank had leased the building to the Brockman Building Company (not to be confused with the taxpayer), which had issued bonds of face value of about $92,000 to the Pacific Indemnity Company and Pioneer Securities Corporation (hereinafter referred to as the bondholders). (R. 128, 644.)

In 1933, in a financial rearrangement, the bank leased the building to the taxpayer for 28 years. The taxpayer did not occupy the premises, but subleased the space and managed the building. Its lease with the bank provided, among other things, that the taxpayer would pay to the bank all gross receipts, less certain listed operating expenses. The lease was subject to cancellation if net rentals from March 1, 1933, to July 31, 1942, did not average $3,500 per month. If the net rentals averaged $3,500 or more per month, the rental after July 31, 1942, was to be fixed at that amount, the taxpayer to retain any excess. In order to obtain the lease, the taxpayer was required to agree to purchase the aforementioned bonds. Accordingly, it entered into a written agreement with the bondholders, obligating itself to make payment from any rentals which it received in excess of $3,500 per month. As security for this obligation, the taxpayer assigned

its lease to the bondholders, and its stockholders pledged to the bondholders all of their stock in the taxpayer. (R. 128–129, 643–644.)

The taxpayer failed to realize an average net rental of $3,500 per month from its subletting of the premises. In fact, by March 31, 1942, the delinquency in its payment of minimum rentals to the bank exceeded $100,000. (R. 130, 644.)

During the taxable years, the taxpayer's principal sublessee was J. J. Haggarty Stores, Inc. (hereinafter referred to as Haggarty). Haggarty also leased premises adjoining the Brockman Building, using both locations for its business. Its sublease of the Brockman Building and its lease of the adjoining building were both to expire on March 14, 1942. Haggarty was therefore required either to obtain renewals or to make plans for doing business elsewhere. Since it appeared likely that on July 31, 1942, the taxpayer would be in default on its lease from the bank, in which event that lease was subject to cancellation, Haggarty would accept a renewal of the sublease from the taxpayer only if the bank would agree to be bound thereto as lessor and if the bondholders would consent to be bound to the renewal. (R. 130, 644.)

Despite the default in the payment of minimal rentals under its lease with the bank, the taxpayer had efficiently managed the Brockman Building and had obtained for the bank as much rental as possible under the circumstances. The tax-

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payer therefore had reasonable prospects of avoiding cancellation of its lease with the bank if it could obtain some increased income from the premises. With this in mind, the taxpayer had begun negotiations for a new sublease to Haggarty about two years before the expiration date of the existing sublease. The negotiations were carried on with the bank's knowledge and were handled principally by three officers of the taxpayer, two of whom were also stockholders at the time. (R. 131, 644–645.)

Actually, more than one plan was considered whereby the taxpayer could remain as the bank's lessee and Haggarty could continue to occupy the building. At the end of 1941, a proposed sublease for Haggarty was submitted to the bank. It provided for the payment of an increased amount of fixed rental, and for contingent rentals equal to a percentage of Haggarty's gross sales over a certain amount. The fixed rental was to be paid over to the bank. The contingent rentals were to be retained by the taxpayer and assigned by it to one of its officer-stockholders or to his nominees, who were to be the taxpayer's shareholders and the bondholder-creditors. The bank refused to consent to this sublease because of its apprehension that inclusion of the contingent and fixed rental provisions in the same agreement would cause it "to have in the lease a partner [the taxpayer's stockholders], whose percentage in-

terest might affect [its] fixed interest." (R. 131–132, 645, 649.)

Because of the bank's reluctance to enter into the proposed agreement, the taxpayer's stockholders and attorneys found (R. 649) that "it would be necessary to segregate from the lease those provisions relating to percentage rentals." Accordingly, another plan was executed. Under it, on March 3, 1942, Haggarty entered into a new sublease with the taxpayer, to extend until September 30, 1961. This sublease, to which the bank and the bondholders consented, provided only for a fixed rental of $5,500 per month. On the same date, Haggarty entered into a separate agreement with the Title Insurance and Trust Company (hereinafter referred to as the Title Company), under which Haggarty was to pay to the Title Company certain percentages of gross sales determined in the same way as the contingent rentals under the rejected plan. It was necessary for Haggarty to agree to the payment of a percentage of its sales in order to obtain a new sublease from the taxpayer. The bank relinquished any possible future claims to the percentage payments. (R. 132–133, 645.)

On August 12, 1942, the Title Company executed a declaration of trust (hereinafter referred to as the Haggarty trust), wherein, as trustee, it obligated itself to pay the percentages received from Haggarty (less its compensation and the expenses of the trust) to the then named stock-

holders of the taxpayer in proportion to their stockholdings, and to the taxpayer's bondholder-creditors, as follows (R. 133–134):

55 Per Cent of Net Payments

Beneficiary	*Proportion*
Pioneer Securities Corp.	17/92
Pacific Indemnity Company	75/92

45 Per Cent of Net Payments

John Shirley Ward	85/1,000
Chandler P. Ward	85/1,000
Shirley C. Ward, Jr.	85/1,000
Robertson Ward	85/1,000
Katherine Ward Carr	85/1,000
Beatrice Ward Challis	85/1,000
Emma B. C. Wells	245/1,000
Harold S. Chase	245/1,000

The Haggarty trust declaration was signed only by the Title Company and the beneficiaries. Distributions to the bondholders were to cease when they equalled $92,000, the face amount of the outstanding bonds. It was agreed that when the balance of the bonds was paid, the interest of the bondholders in the "trust and in the lease should terminate" and that "any excess [would] then pass to the stockholders in accordance with their stock interests." (R. 645–646.)

The individual beneficiaries of the Haggarty trust were at all pertinent times all the stockholders of the taxpayer, with one exception. Harold S. Chase owned 245 shares of taxpayer's stock which he had acquired from David Blankenhorn on September 24, 1936, and on August 24, 1945, Blankenhorn reacquired the shares from Chase. On the latter date, Chase assigned his

undivided 245/1000 interest in the Haggarty trust to Blankenhorn and Harold C. Morton. On September 17, 1947, Blankenhorn and Morton executed assignments whereby, in effect, each received a whole interest in an undivided 122.5/1000 beneficial interest in the Haggarty trust in exchange for his one-half of an undivided 245/1000.[1] Morton was never a stockholder in the taxpayer. (R. 135, 136.)

In November, 1946, the Haggarty trust was amended with the consent of the Title Company and all of the beneficiaries, including Morton. Haggarty, the bank, and the taxpayer were not parties to this agreement. In June, 1947, the Brockman-Haggarty sublease was amended in details not here relevant. Neither the Title Company nor any of the beneficiaries of the Haggarty trust were parties to the amendment. On November 30, 1948, the percentage of sales agreement of March 3, 1942, between Haggarty and the Title Company was amended with the consent of all of the beneficiaries of the Haggarty trust. The taxpayer and the bank were not parties to this amendment. (R. 136–137.)

The bondholders were paid in full by June 1, 1945. On June 14, 1945, they reassigned the taxpayer's lease and the pledged stock which they

[1] The beneficial interests under the Haggarty trust were transferable in part, but only with the consent of the trustee and the written acceptance of the transferee, together with his promise to pay a transfer fee. (R. 136.)

had held as security, and they surrendered the bonds to the taxpayer. During the period 1942 to 1949, inclusive, the stockholders received $590,000 from the Haggarty trust. In its own records, Haggarty treated the payments into the trust as payments of rent. (R. 136, 139–141, 645.)

The Tax Court found that the arrangements whereby the contingent rentals were to be paid into the Haggarty trust for the benefit of the taxpayer's stockholders and creditors were merely a change in form from the plan which previously had been rejected by the bank, and that the activities of the taxpayer's officers in bringing about this new arrangement were performed on behalf of the taxpayer and not on behalf of the stockholders and creditors of the taxpayer, as such. (R. 135.) It further found that the several steps by which this result was achieved—the new Haggarty sublease, the agreement between Haggarty and the Title Company, the Title Company's declaration of trust in favor of the bondholders and the named stockholders of the taxpayer, the assent of the bank to the contingent payments agreement, the bondholders' assent to the new arrangement and the bank's agreement to be bound as lessor to Haggarty in the event of the taxpayer's default—were all part of a single plan whereby the percentage payments made by Haggarty and distributed to the taxpayer's stockholders and bondholder-creditors

constituted in effect the taxpayer's compensation for the management of the premises. The Tax Court concluded that the percentage payments were therefore income to the taxpayer. The Court of Appeals affirmed. (R. 135, 147, 153, 646, 648, 650.)

ARGUMENT

1. In holding that the Haggarty contingent payments—which, except in minor and immaterial instances, were made in full to the taxpayer's stockholders and its bondholder-creditors—constituted the taxpayer's income, the decision below is correct and embodies a proper application of established principles. The taxpayer, the owner of a leasehold interest from the bank, subleased the premises in question to Haggarty. Haggarty agreed to pay (1) a fixed rental to the taxpayer, which was to be turned over entirely to the bank, and (2) contingent amounts, determined by sales percentages, to the beneficiaries of a trust who were the taxpayer's stockholders and bondholder-creditors. This resolution of the situation which existed in 1942—when Haggarty's original sublease with the taxpayer was about to expire and when the taxpayer's basic lease with the bank appeared headed for possible cancellation because of the default in the minimum rental payments—was found by both courts below to be a mere change in form from a plan, previously concluded in 1941, which called for Haggarty's

payment *to the taxpayer* not only of the fixed rental to be paid over to the bank, but also of contingent rentals which the taxpayer itself was to receive and then pay over to one of its stockholders or his nominees, the taxpayer's stockholders and the bondholder-creditors. Both courts below agreed that the contingent payments represented the taxpayer's compensation for managing the Brockman Building and that the source of that income, from which all the rentals derived (R. 648), "was the leasehold interest [which was] vested entirely in [the taxpayer] * * *."

This essentially factual determination, concurred in by both courts below, would present no occasion for further review by this Court even if its correctness were doubtful. But it is clear that the decisions below are correct. Indeed, a contrary finding—that the contingent payments were the exclusive income of the trust beneficiaries—would have been, as the Tax Court observed (R. 153), an "incredible ultimate conclusion", for it would have reduced the taxpayer to a managing corporation without compensation or hope of compensation for its function of management.

Accordingly, the courts below properly concluded that the series of steps taken in 1942—"all executed as parts of a single plan" (R. 135)—constituted an anticipatory arrangement whereby the taxpayer's income, in the form of

the contingent rental payments on the Haggarty sublease, was passed directly to the taxpayer's stockholders and bondholder-creditors. The decision that the payments remained taxable as the taxpayer's income accords with the basic doctrine that income is taxable to the one who earns it, and that this result cannot be avoided by anticipatory assignments regardless of the form they assume. *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136; *Douglas* v. *Willcuts*, 296 U. S. 1; *Helvering* v. *Clifford*, 309 U. S. 331; *Harrison* v. *Schaffner*, 312 U. S. 579; *Commissioner* v. *Tower*, 327 U. S. 280; *Commissioner* v. *Sunnen*, 333 U. S. 591; *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422; *Raybestos-Manhattan Co.* v. *United States*, 296 U. S. 60; *Blair* v. *Commissioner*, 300 U. S. 5.

2. There is no conflict of decisions. Far from being inconsistent with *United States* v. *Joliet & Chicago R. Co., supra,* as petitioner asserts (Pet. 11), the decision here is actually indistinguishable in principle from that case. There, the taxpayer-lessor had made a perpetual lease of its property, and the Court of Appeals had held that under local law it was divested of all right, title and interest in the property. Addressing itself to the taxpayer's contention—similar to the one made here—that since it no longer owned or controlled the income-producing res it could not be taxed with the annual payments which the

lessee had made directly to the stockholders, this Court said that (p. 46) "Such considerations do not dispose of this controversy." Since the corporation there, which conducted no further business and remained in existence only to maintain a transfer book, was held taxable on the payments made by the lessee to its stockholders, the situation in the instant case—where the taxpayer was the owner of the basic lease from the bank, which was the income-producing source of both the fixed and contingent rentals, and where the taxpayer continued to render the management services for which it existed—is all the stronger for taxability.

Similarly mistaken is the assertion (Pet. 11) that the decision below is contrary to the rules in *Harrison* v. *Schaffner,* 312 U. S. 579, and *Blair* v. *Commissioner,* 300 U. S. 5. The actual holding in *Schaffner*—that the life beneficiary of a trust who had assigned portions of the trust income for two years to members of her family nevertheless remained taxable on the amounts paid to the assignees—is in accord with the decision below. And *Blair* is distinguishable. There, this Court held that the life beneficiary of a trust who, under state law, had validly conveyed interests therein to his children, was not taxable on the amounts which were paid them. The holding was explicitly based on the fact that the assignees alone were the complete owners of the specific interests in the

trust which were conveyed to them. Significantly, this Court admonished (p. 11):

> The tax here is not upon earnings which are taxed to the one who earns them. Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation.

The instant case falls within these excluded categories. During all of the taxable years, the taxpayer owned its basic leasehold interest from the bank. All of the contingent amounts paid by Haggarty were in substance its earnings, as rentals under the sublease, serving in fact as its compensation for managing the Brockman Building. That portion of the contingent amounts which were paid over to the taxpayer's bondholder-creditors constituted its income for the additional reason that the payments were in discharge of its obligation. *Raybestos-Manhattan Co.* v. *United States, supra; Blair* v. *Commissioner, supra.*

Finally, *Denholm & McKay Realty Co.* v. *Commissioner,* 139 F. 2d 545 (C. A. 1), with which the taxpayer urges a conflict (Pet. 11), does not undertake to state a rule different from the controlling principle of *United States* v. *Joliet & Chicago R. Co., supra.* The decision in *Denholm*—that the lessee's guaranty of dividends to the lessor's stockholder was not intended or paid as rent—turns on its own special facts, which the Court of Appeals there characterized

as "somewhat peculiar" (p. 546) and which the Tax Court in the instant case described as "unusual" (R. 152). The particular circumstances of that case, which differentiate it from this one and dispel the claim of conflict, are aptly summarized in the opinion of the Tax Court, which said (R. 152):

> Among other things, [in *Denholm*] the taxpayer corporation and the corporation guaranteeing the dividends on the taxpayer's preferred stock were subject to control by the same person at the time the arrangement in controversy was adopted; the preferred stock was then held by the guarantor corporation; and it was then the intention of the guarantor corporation to exchange such preferred stock for its own outstanding preferred stock, thus in effect guaranteeing its own preferred stockholders a specified dividend through the medium of the taxpayer corporation's preferred. We mention these unusual aspects of the Denholm case not because any one of them is to be singled out as the crucial factor upon which the case should be regarded as resting, but rather because the peculiar situation there presented sets the case apart from the general rule applied in the Joliet case.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari should be denied.

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